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Pure Cycle

Pure Cycle is a company with assets and present and future cash flows from five business areas: water and wastewater utilities, supplying water to hydraulic fracturing operations in Colorado, development of a real estate development project on the I-70 Corridor and developing oil & gas assets.

Industrials – Utilities April 12, 2017

2Q:17 Results Mixed; Raising PT to $6.55 on Sky Ranch Development Upside in FY:18

(PCYO - $5.50) BUY

Key Points

- **Pure Cycle (PCYO) reported 2Q:17 results slightly below our expectations with revenue of $273k versus our $309k estimate. Loss per share for the quarter was inline with our ($0.01) estimate.**

2Q:17 RESULTS

	2Q:17 Actual	2Q:17 Estimate	Variance	2Q:16 Actual
Total Revenue	$ 237,078	$ 308,511	$ (71,433)	$ 76,442.0
Gross Margin	28.9%	54.9%	-26.0%	-58.2%
Operating Income	$ (455,414)	$ (390,160)	$ (65,254)	$ (556,731)
Adj. Diluted EPS	$ (0.01)	$ (0.01)	-	$ (0.01)

- **Frack water sales were light of our estimate for the quarter as PCYO continued to delivery frack water for one oil well operator. We are lowering our estimates for frack water sales for the remainder of FY:17 as the buildout of wells in the company's service area are pushed into 4Q:17.**
- **Gross margins improved to 28.9% from (58.2)% in the previous year quarter from increases in frack water sales but were lower than the 54.9% we had modeled due to lower frack water sales volumes.**
- **PCYO closed the Wild Pointe water system acquisition in the second quarter which will likely add $140k in annual revenues with potential to recognize an additional $2.5M in tap fees and increase annual revenues to $350k at full build-out.**
- **We would expect to see home builder commitments within the next 60 to 90 days with deposits and lot takeout agreements signed. Homes should then be available for delivery beginning in 1Q:18.**
- **We are raising our estimates for both FY:17 and FY:18 due to the inclusion of the Wild Pointe acquisition. We are maintaining our BUY rating and raising our price target to $6.55 from $6.18 price target as the company continues to benefit from increased frack water sales and the outlook for Sky Ranch becomes more visible.**

INVESTMENT HIGHLIGHTS

We continue to see significant upside to PCYO in the long term. The Sky Ranch development will provide significant cash flows for the company once lot sales and water tap fees begin in FY:18. We see near term upside in the company's frack water sales and long-term growth both organically with Sky Ranch and through acquisitions like Wild Pointe. We are maintaining our BUY rating and raising our price target to $6.55 from $6.18. Our price target is derived from the midpoint of two sum-of-the-parts scenarios.

Financial Summary

Rev(mil)	2016A	2017E	2018E
Nov	$0.126	$0.199A	$3.13E
Feb	$0.076	$0.237A	$3.10E
May	$0.101	$0.293E	$3.11E
Aug	$0.149	$0.504E	$3.29E
FY	$0.452	$1.23E	$12.63E
P/Sales	nm	nm	nm

EPS	2016A	2017E	2018E
Nov	$(0.00)	($0.01)A	$0.02E
Feb	$(0.01)	($0.01)A	$0.03E
May	$(0.02)	($0.01)E	$0.03E
Aug	$(0.03)	($0.01)E	$0.01E
FY	$(0.06)	$(0.06)E	$0.09E
P/E	nm	nm	nm

Price:	$5.50
52-Week Range:	$5.93-$4.30
Target:	$6.55
Rating:	BUY
Shares Outstanding:	24 mil
Mkt. Capitalization:	$133 mil
Ave. Volume:	33,100
Instit. Ownership:	62%
BV / Share:	$2.95
Debt/Tot. Cap. (ex-tap):	0%
Est. LT EPS Growth:	NM

2Q:17 RESULTS

Total company sales were $237,100 versus our $308,500 estimate, the majority of the miss came from lower frack water sales than expected. Segment revenue consisted of $190,700 in metered water usage, $11,200 from wastewater treatment fees, recognition of $13,800 from special facility funding and water tap fees as well as $21,200 from consulting fees charged in the quarter. 1Q water revenues benefitted from delivery of frack water to one well within PCYO's service area. Gross margins for water delivery increased quarter over quarter as the company was able to offset a majority of fixed operating costs with increased frack water sales compared to the prior year quarter. Water delivery gross margin was 59% compared to (114%) in the prior year quarter. G&A expense was $449,500 for the quarter which was below our $484,000 estimate but was the largest driver of a net loss of ($317,300) or ($0.01) per share which was inline with our estimate.

WILD POINTE ACQUISITION

The company closed its water service provider agreement for Wild Pointe in Elbert County Colorado which is just south of the company's Lowry Range service area. The company will provide water services to the Wild Pointe Ranch development which consists of 120 connections for both residential and commercial customers. This acquisition will begin to contribute meaningfully to revenues as the company begins to recognize water tap fees and recurring water service revenues from this acquisition beginning in 3Q:17. The company should see development continue on an on-going basis for the next several years as the community reaches full build-out of 300 SFEs. This should generate annual water service revenue near $350,000 and $2.5M in tap fees over the development phase.

FRACK WATER SALES GROWTH

The company recognized $141,500 in frack water sales in 2Q:17 from one oil and gas well being operated in PCYO's service area. The company has seen increased activity within the area and we think it is likely that two more operators begin fracking within the company's service area throughout the back-half of the FY:17. We are however slightly lowering our estimates for frack water sales over the back half of the year as well activity begins to ramp later than we previously had modeled. Our outlook for frack water sales has increased for FY:18 and we are now including frack water sales at roughly 12 wells by the end of FY:18. The inclusion of frack water sales increases FY:18 revenue by roughly $1.20M and EBITDA by $0.96M.

SKY RANCH OUTLOOK

Sky Ranch discussions with homebuilders are on-going but are likely to be ratified within 90 days. This would provide meaningful details on the timing of phasing, lot takedowns and deposits from homebuilders and we think would be a major plus for the stock as more clarity is given around the timeline and builders appetite for takedowns. It is likely that concurrent development with multiple builders will happen as soon as contracts are signed and final grading is wrapped up in early summer. Lots are still set to be sold beginning late this summer and finished homes are to be delivered in 1Q:18. We think the ramp of lot sales will build over the first year as builders finish homes and other development activity surrounding Sky Ranch spurs further development.

VALUATION AND MODEL CHANGES

We are raising our estimates for both FY:17 and FY:18 due to the inclusion of the Wild Pointe acquisition. We also updated our model to include all tap fees as revenues in the period recognized from our previous method of capitalizing costs related to tap infrastructure and recognizing revenues over the depreciable period of the assets. This raises our revenue going forward in all period of the model where water tap fees were recognized. The company provided more clarity on the accounting for water tap fees and we think that this change to our model is warranted to better align cash flows with revenues in the period they occur.

We included the acquisition of Wild Pointe after the acquisition closed and going forward this acquisition will contribute $140,000 in annual water service revenue with additional water tap fees and water service revenue building over the next several years of development.

We updated our model for improved oil and gas prices and included frack water sales in FY:18 that were previously excluded due to the unpredictable nature of fracking activity within the company's service area. We are now more confident that market fundamentals have improved to a point that will offer enough benefit for operators to continue to increase drilling activity in the Niobrara formation.

Our FY:17 revenue estimate increases to $1.23M from $1.20M due mainly to the inclusion of the Wild Pointe acquisition and our FY:18 revenue estimate increases to $12.6M from $8.34M due mainly to the accounting recognition of water tap fees being recognized in the period in which the sale is concluded as opposed to our previous method of capitalization and revenue recognition over the depreciable life of the asset. FY:17 EPS is not changed at $(0.06) while FY:18 EPS rises to $0.09 from $(0.02). We are maintaining our BUY rating and raising our price target to $6.55 from $6.18 price target as the company continues to benefit from increased frack water sales and the outlook for Sky Ranch becomes more visible.

We rate the shares of Pure Cycle a BUY and our price target is based on a sum of the parts analysis. Our $6.55 price target is derived from the midpoint of two scenarios: in our valuation we value PCYO's water utilities at $2.06 a share, the development value of Sky Ranch and Wild Pointe at $2.20 a share, which includes $1.09 a share from lot sales and $1.11 a share from tap fees, additional water projects are valued at $0.50 stemming from additional water and wastewater service revenues and tap fees from surrounding developments, the likely oil and gas royalties from Sky Ranch and surrounding area at $0.12 a share, the potential for future frack water sales at $1.67 a share.

Target Price Valuation Equally weighted base case and upside case		
Water Utilities @ 50% probability for additional projects completed	$	2.06
Lots Sales	$	1.09
Tap Fees	$	1.11
Additional Projects Tap Fees @ 50% probability	$	0.50
Oil and Gas Royalties	$	0.12
Oil and Gas Frack Water	$	1.67
Price Target	$	6.55

Feltl and Company Estimates

INVESTMENT THESIS

The company continues to make progress on both organic growth through Sky Ranch and inorganic growth through their acquisition of Wild Pointe Ranch's water service rights. Although these developments add near term benefits most of the transformative opportunity for the company still remains with in the long term development of Sky Ranch. We think the clarity of homebuilder contracts will provide a more favorable outlook for the company and the beginning of lot sales and home sales in FY:18 will substantially increase the company's financial performance.

PureCycle Corp. (PCYO)
Earnings Model Summary

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Years ending August 31	1Q-16	2Q-16	3Q-16	4Q-16	1Q-17A	2Q-17A	3Q-17E	4Q-17E	1Q-18E	2Q-18E	3Q-18E	4Q-18E	2016A	2017E	2018E
Income Statement															
Revenues:															
Metered water usage	$ 56,780	$ 27,393	$ 35,659	$ 101,165	$ 141,101	$ 190,665	$ 174,511	$ 369,990	$ 391,587	$ 356,137	$ 363,757	$ 533,577	$ 220,997	$ 876,267	$ 1,645,058
Wastewater treatment fees	10,303	10,700	10,537	12,172	12,323	11,225	11,743	12,370	19,812	22,208	25,382	29,967	43,712	47,662	97,369
Special facility funding recognized	10,377	10,377	10,377	10,377	10,377	10,377	10,377	10,377	10,377	10,377	10,377	10,377	41,508	41,508	41,508
Water tap fees recognized	3,574	3,573	3,574	3,574	3,574	3,573	65,974	81,574	806,174	806,174	806,174	806,174	14,295	154,695	3,224,696
Lot Sales									1,875,000	1,875,000	1,875,000	1,875,000			7,500,000
Farm operations													-	-	-
Other	44,876	24,399	40,705	21,670	31,723	21,238	30,000	30,000	30,000	30,000	30,000	30,000	131,650	112,961	120,000
Total revenues	125,910	76,442	100,852	148,958	199,098	237,078	292,605	504,311	3,132,950	3,099,896	3,110,690	3,285,095	452,162	1,233,092	12,628,631
Expenses:				-											
Water service operations	(67,316)	(58,476)	(65,184)	(73,448)	(79,865)	(77,701)	(56,294)	(151,398)	(113,921)	(92,651)	(97,223)	(199,115)	(264,424)	(365,258)	(502,912)
Wastewater service operations	(7,074)	(6,195)	(7,286)	(8,632)	(7,576)	(7,393)	(7,046)	(7,422)	(11,887)	(13,325)	(15,229)	(17,980)	(29,187)	(29,437)	(58,421)
Farm operations				-									-	-	-
Developmental Costs	-	-	-	-	-	-	-	-	(1,901,300)	(1,901,300)	(1,901,300)	(1,901,300)	-	-	(7,605,200)
Depletion and depreciation	(41,655)	(41,575)	(41,604)	(41,836)	(41,805)	(67,575)	(70,297)	(70,297)	(70,297)	(70,297)	(70,297)	(70,297)	(166,670)	(249,974)	(281,188)
Other Expense	(15,928)	(14,682)	(20,763)	(17,105)	(16,261)	(16,011)	(24,000)	(24,000)	(24,000)	(24,000)	(24,000)	(24,000)	(68,478)	(80,272)	(96,000)
Total cost of revenues	(131,973)	(120,928)	(134,837)	(141,021)	(145,507)	(168,680)	(157,637)	(253,117)	(2,121,405)	(2,101,573)	(2,108,050)	(2,212,692)	(528,759)	(724,941)	(8,543,721)
Gross (loss) profit	(6,063)	(44,486)	(33,985)	7,937	53,591	68,398	134,968	251,194	1,011,544	998,323	1,002,641	1,072,402	(76,597)	508,151	4,084,911
General and administrative expenses	(439,799)	(449,334)	(431,737)	(528,873)	(443,240)	(449,545)	(506,000)	(616,000)	(510,214)	(400,572)	(437,218)	(851,996)	(1,849,743)	(2,014,785)	(2,200,000)
Depreciation	(52,916)	(62,911)	(67,172)	(70,435)	(73,987)	(74,267)	(75,752)	(77,267)	(78,813)	(80,389)	(81,997)	(83,637)	(253,434)	(301,274)	(324,835)
Operating loss	(498,778)	(556,731)	(532,894)	(591,371)	(463,636)	(455,414)	(446,784)	(442,073)	422,517	517,362	483,426	136,770	(2,179,774)	(1,807,907)	1,560,075
Other income (expense):				-											-
Oil and gas lease income, net	161,430	161,430	31,905	6,000	5,265	6,000	5,500	2,000					360,765	18,765	-
Oil and gas royalty income, net	122,146	72,456	76,400	72,618	68,128	71,275	70,223	66,845	63,630	60,569	57,656	54,883	343,620	276,471	236,738
Interest Income	63,821	77,579	66,253	33,626	73,566	66,098	66,250	66,250	66,250	66,250	66,250	66,250	241,279	272,164	265,000
Interest Expense				-									-	-	-
Other	(4,268)	3,208	(2,671)	7,583	(2,615)	(2,600)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	3,852	(9,215)	(8,000)
(Loss) gain on sale of land and water assets				-									-	-	-
Interest imputed on the Tap Participation Fee payable to HP A&M				-									-	-	-
Net (loss) income from continuing operations	(155,649)	(242,058)	(361,007)	(471,544)	(319,292)	(314,641)	(306,811)	(308,978)	550,397	642,181	605,332	255,903	(1,230,258)	(1,249,722)	2,053,813
(Loss) income from discontinued operations, net of taxes	58,108	(28,641)	(61,263)	(48,552)	(18,680)	(2,649)	(2,517)	(2,391)					(80,348)	(26,236)	-
Taxes				-									-	-	-
Net (loss) income	(97,541)	(270,699)	(422,270)	(520,096)	(337,972)	(317,290)	(309,328)	(311,369)	550,397	642,181	605,332	255,903	(1,310,606)	(1,275,958)	2,053,813
Unrealized holding losses	-	13,182	(35,517)	25,457	(22,211)	(12,682)							3,122	(34,893)	-
Total comprehensive (loss) income	$ (97,541)	$ (257,517)	$ (457,787)	$ (494,639)	$ (360,183)	$ (329,972)	$ (309,328)	$ (311,369)	$ 550,397	$ 642,181	$ 605,332	$ 255,903	$ (1,307,484)	$ (1,310,851)	$ 2,053,813
Basic and diluted net income (loss) per common share:															
Loss from continuing operations	$ (0.00)	$ (0.01)	$ (0.02)	$ (0.02)	$ (0.01)	$ (0.01)	$ (0.01)	$ (0.01)	$ 0.02	$ 0.03	$ 0.03	$ 0.01	$ (0.05)	$ (0.06)	$ 0.09
(Loss) earnings from discontinued operations	*	*	*												-
Net Loss	$ (0.00)	$ (0.01)	$ (0.02)	$ (0.02)	$ (0.01)	$ (0.01)	$ (0.01)	$ (0.01)	$ 0.02	$ 0.03	$ 0.03	$ 0.01	$ (0.05)	$ (0.06)	$ 0.09
Weighted average common shares outstanding – basic	23,912,323	23,754,098	23,754,098	23,781,041	23,754,098	23,754,098	23,754,098	23,754,098	23,754,098	23,754,098	23,754,098	23,754,098	23,781,041	23,754,098	23,754,098
Weighted average common shares outstanding – diluted	23,912,323	23,754,098	23,754,098	23,781,041	23,754,098	23,754,098	23,754,098	23,754,098	23,754,098	23,754,098	23,754,098	23,754,098	23,781,041	23,754,098	23,754,098

Analyst Certification

I, **Aaron R. Steele**, certify that the views expressed in this research report accurately reflect my personal views about the subject company and its securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation related to the specific recommendations expressed in this report.

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Strong Buy: The stock is expected to have total return potential of at least 20%. Catalysts exist to generate higher valuations, and positions should be initiated at current levels.
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Sell: Expect a negative total return of at least 10%. Current positions may be used as a source of funds.

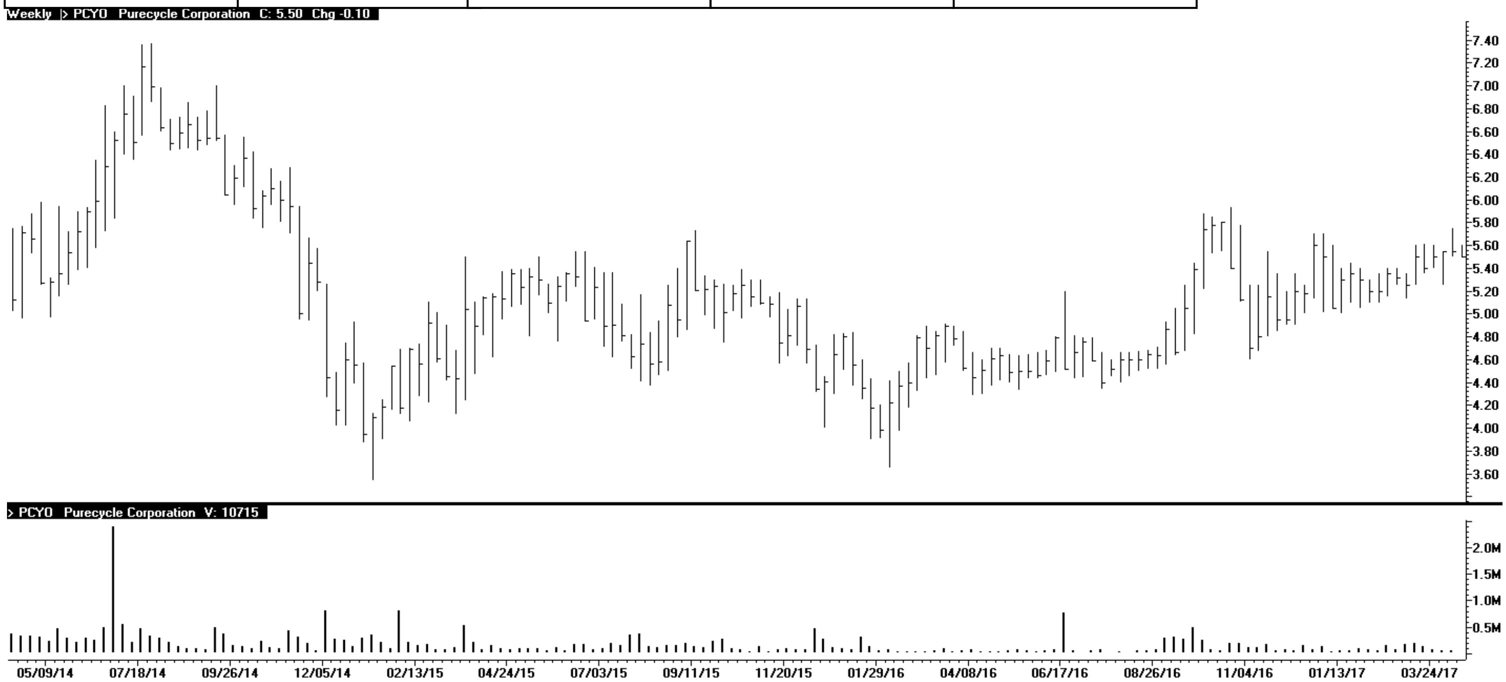
4/12/2017

Ratings Distribution for Feltl and Company

Rating	Number of Stocks	Percent of Total	------ Investment Banking ------ Number of Stocks	Percent of Rating category
SB/Buy	34	67%	2	6%
Hold	15	29%	0	0%
Sell	2	4%	0	0%
	51	100%	2	4%

The above represents our ratings distribution on the stocks in the Feltl and Company research universe, together with the number in (and percentage of) each category for which Feltl and Company provided investment-banking services in the previous twelve months.

05/06/13 STRONG BUY Target: $12.00	01/13/15 STRONG BUY Target: $9.00	03/18/15 STRONG BUY Target: $8.25	12/12/16 BUY Target: $6.18	04/12/17 BUY Target: $6.55



Date	Nature of Report	Rating	Price Target
05/06/13	Initiation @ $6.28	STRONGBUY	$12.00
01/13/15	1Q results beat us	STRONGBUY	$9.00
03/18/15	Sale of agriculture should give capital to develop Sky Ranch	STRONGBUY	$8.25
12/12/16	Long-Term Growth of Sky Ranch Remains Attractive	BUY	$6.18
04/12/17	2Q:17 Results Mixed; Raising PT to $6.55	BUY	$6.55

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Valuation and Price Target Methodology:

We considered a sum of the parts analysis technique in appraising the valuation of Pure Cycle. Our price target relies significantly on individual valuation estimates for each business segment of PCYO.

Risks to Achievement of Estimates and Price Target:

- The development of Pure Cycle's water utilities will be a comprehensive and long-term undertaking. Economic issues, regional issues, and other factors may significantly influence how this business develops.
- Water has become increasingly political in some states and changes in the public perception or regulatory environment could impair PCYO's outlook.
- The hydraulic fracturing activity is just getting started in PCYO's trade area, and we cannot be sure of the size or speed of the development of this demand.
- The development of PCYO's oil and gas assets is just getting started and faces significant hurdles to achieving success.
- The development of Sky Ranch will take many years and significant effort. Again, regional or local economic issues could alter the success or timing of this effort.
- Agriculture is a cyclical industry and the rents and income PCYO anticipates will likely see substantial variations over time.

Other Disclosures:

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